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INFO RUEHSS/OECD POSTS COLLECTIVE PRIORITY
RUEHBJ/AMEMBASSY BEIJING PRIORITY 1375
RUEHUL/AMEMBASSY SEOUL PRIORITY 7439
RUEHFK/AMCONSUL FUKUOKA PRIORITY 5776
RUEHHK/AMCONSUL HONG KONG PRIORITY 6429
RUEHNH/AMCONSUL NAHA PRIORITY 8172
RUEHOK/AMCONSUL OSAKA KOBE PRIORITY 9443
RUEHKS/AMCONSUL SAPPORO PRIORITY 6384
RUCPDO/DEPT OF COMMERCE WASHINGTON DC PRIORITY
RUEHGV/USMISSION GENEVA PRIORITY 3232
RHMFISS/USFJ PRIORITY
RUEHIN/AIT TAIPEI PRIORITY 6871
RHHJJPI/PACOM IDHS HONOLULU HI PRIORITY
RUEAIIA/CIA WASHDC PRIORITY

C O N F I D E N T I A L SECTION 01 OF 03 TOKYO 000231

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SUBJECT: FEARS OF DOWNTURN IN U.S. SPARK CONCERNS IN JAPAN

REF: TOKYO 163

TOKYO 00000231 001.2 OF 003

Classified By: Ambassador J. Thomas Schieffer for reasons 1.4 (b/d)

11. (SBU) Summary. Weakening economic data from the United States and global financial market volatility are sparking fears that a recession in Japan may not be far behind. In fact, Japanese economic growth is slowing, public and private forecasts have been revised downward over the past several months, and downside risks to the outlook are growing, particularly higher oil prices and the effects of slower economic growth in the United States on Japanese exports and Japan's other export markets. Nevertheless, most forecasters are projecting positive, albeit slower, real economic growth in Japan over the remainder of the current and coming fiscal years, largely reflecting projected firm business investment and weaker but still supportive net exports. The prospect of slower growth has prompted a number of Japanese economic policymakers to express concerns. End Summary.

12. (SBU) Over the past several months, Japan's economy has slowed due to a variety of factors. Botched implementation of the revised Building Standards Law in July resulted in plunging housing investment, with new housing starts down 37 percent in the July to September quarter over a year earlier and falling at a still sharp but slightly lower rate of 27 percent in November 2007 over the prior November. Higher oil and commodity prices are affecting profits at small to medium-sized firms, thus limiting their ability to invest, hire and raise wages. The December Bank of Japan (BOJ) tankan survey reported a deterioration in business sentiment for large manufacturers, likely related to an expected slowdown in the U.S.. Consumer sentiment fell to its lowest level in four years, as increases in food and gasoline prices outstripped wage growth, pinching disposable income. When asked recently about their living standards, 3.4% of those

surveyed reported an improvement over the previous year, while 53.4% said conditions had worsened, the widest gap since March 2003. In addition, the Nikkei 225 stock index has fallen 12 percent in 2008.

13. (U) In early December, the Cabinet Office cut its estimate of real GDP growth for the July-September quarter from 2.6 to 1.5 percent. The initial estimate had already anticipated the drop in housing investment. The revision reflected lower than previously estimated business investment and a larger drawdown of inventories. As a result, the contribution of final domestic demand to third quarter growth was flat; net exports accounted for all the growth. Taking the third quarter revision into account and anticipating some continued weakness in housing investment in the October-December quarter, the Cabinet Office lowered its projection later in December for FY2007 real GDP growth from 2.1 to 1.3 percent. At the same time, the Cabinet Office released its first official forecast for real GDP growth of 2 percent in FY2008. This forecast assumes a rebound in housing investment, higher business investment, a similar level of personal consumption, and a lower level of contribution to growth from net exports when compared to FY2007.

14. (SBU) A Finance Ministry survey released on January 21 downgraded the economic performance assessment of five of Japan's eleven regions, though the report maintained an overall assessment that the national economy as a whole continues to recover. This reporting reconfirmed concerns about regional disparities among many Japanese observers.

15. (C) Following this week's BOJ Monetary Policy Board meeting, which ended on January 22, the Bank of Japan indicated its projection of FY2007 growth in the upper half of the 1 percent range in its October 2007 outlook has

TOKYO 00000231 002.2 OF 003

"deviated somewhat downward." The BOJ further stated "Japan's economy is expanding moderately as a trend, although the pace of growth seems to be slowing mainly due to the drop in housing investment." On January 25, BOJ Governor Fukui confirmed BOJ projections for FY2007 were in line with those of the government and that growth would "probably be in the low one percent range." Perhaps optimistically, the BOJ report after the Monetary Policy Board meeting stated "with a virtuous circle of growth in production, income and spending remaining basically intact, in fiscal 2008 the rate of real GDP growth is likely to be broadly as projected, and slightly higher than the potential growth rate." The October projection for FY2008 real GDP growth was in the lower half of the 2 percent range.

16. (SBU) Though a few voices in the private sector have raised the specter of a near-term recession in Japan, consensus private forecasts stand at 1.4 percent for FY2007 and 1.9 percent for FY2008. In these projections, the main downside risks are the performance of the U.S. economy and potential effects on Japanese exports and other Japanese export markets. Another major element affecting projections is the outlook for domestic consumption following deteriorating consumer sentiment and the implications of recent drops in business confidence for wage increases that might bolster consumption.

17. (SBU) In recent days, a number of GOJ officials have commented on the economy, as well as on the sudden market plunge on January 21-22 (see reftel). Financial Services Minister Watanabe focused on the downside risks to the Japanese economy from the U.S. subprime crisis on January 16. Economic and Fiscal Policy Minister Ota told the Diet January 18 that Japan can no longer be called a "top tier" economy, referring to OECD statistics showing that Japan's nominal per capita GDP has fallen from second in the OECD in 1993 to 18th in 2006. On January 22, she noted while Japan's economy remains in recovery, downside risks are growing due to high oil prices and volatile market moves.

¶8. (SBU) On the same day, Finance Minister Nukaga told the press that the economic recovery would continue, supported by private domestic demand, but that he would continue to watch market movements carefully. Prime Minister Fukuda also responded to concerns, pledging to "closely watch risks from the slowing U.S. economy, as well as the effects of changes in the financial and capital markets and rising oil prices on the Japanese economy." A few LDP politicians raised concern over the Cabinet's "watch and see" response, with former LDP Secretary General Hidenao Nakagawa suggesting the government

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should develop policy goals to reassure the international community that Japan will continue to grow. On January 24 and 25, several opposition Democratic Party of Japan (DPJ) politicians called for government programs to address falling stock prices and boost sluggish personal consumption, aiming to criticize the Fukuda Cabinet as Diet deliberations on the FY2008 were set to get underway.

¶9. (C) Comment. Japan's recent gloom has a number of sources -- weaker economic data both in Japan and the U.S., higher oil prices and global financial market volatility. In fact, most projections for Japan call for continued, albeit slower, economic growth, supported by firm business investment, improvement in housing investment as the problems caused by the revised Building Standards Law are worked through, and a still healthy though smaller contribution from net exports.

¶10. (C) While some DPJ politicians have seized on these economic concerns as yet another opportunity to criticize the ruling coalition, the steps that could be taken are limited by Japan's difficult fiscal situation and current very low

TOKYO 00000231 003.2 OF 003

interest rates. A Nihon Keizai (Nikkei) Shimbun editorial on January 24 called on the Cabinet to pull together a package to support the financial markets, but also to "chart a clear course for structural reforms that are crucial for laying the foundation for renewed growth." The second part of that recommendation from Nikkei is the message that the USG has been and should continue delivering to the Japanese government. End Comment.
SCHIEFFER